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Uniqus's response to the Institute of Chartered Accountants of India's (ICAI) Exposure Draft (ED) on Guidance Note on Transfer of Capital Reserve

April 2023

Introduction

The exposure draft is a welcome step in providing guidance on transfer of capital reserve to free reserves including guidance on identification of triggers that call for such a transfer. As per the existing requirement, capital reserves are recognised against unrealised profits arising from certain transactions or events under both the Indian Accounting Standards and the Indian GAAP framework. However, there is no specific guidance around the subsequent utilisation of these reserves.

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Changes proposed by the ED

Through the exposure draft, specific guidance has been provided for utilisation of capital reserves. The proposed recommendations are as follows;

Paragraph 12

a. Any reserve created as per the requirements of the Companies Act or other applicable law cannot be transferred to other reserve except as per the requirements of the applicable law. Few other reserves, which are purely capital in nature, e.g., capital profit on reissuance of forfeited shares, cannot be transferred to free reserves/ retained earnings as underlying transaction is completed.

b. For capital reserves created as per Ind AS or the erstwhile Companies (Accounting Standards) Rules, 2006 (as amended), the amount can be transferred to the retained earnings or other free reserves only when below the following two conditions are met:

   a. The company has realised the underlying amount. The timing when a reserve become realised depends on specific facts and need to be decided considering such specific facts. Appendix to this Guidance Note contain some examples to explain this.

   b. The amount has become available for distribution under the Act or other applicable laws. Each company should evaluate whether amount is available for distribution basis its specific facts and consider involving legal professionals, if needed.

   Till both these conditions are met, the amount should continue to be reflected as capital reserve.

c. The amount as (b) above may be transferred either proportionately each year, i.e., proportionately as assets resulting in capital reserve are depreciated/ impaired/ amortised or at end on sale of the asset.

d. The NCLT Schemes approved under sections 230 to 232 of the Act. Hence, any reserve created under such schemes will also be dealt with using the same principles, i.e., the amount can be transferred to retained earnings or other reserve only if it has become realised and the amount can be used for distribution as per the applicable law.

e. In each year of transfer, the Company should give a detailed disclosure with facts and including (i) amount of capital reserve, (ii) background of transaction, how it arose, (iii) year of its origination, (iv) how it become realised with details of subsequent transaction, and (v) amount that become realised and thereby transferred to free reserve/ retained earnings after appropriate approvals by Board of Directors/ members Audit Committee as applicable.

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Our analysis of the exposure draft

We are largely aligned with the recommendations brought in through the exposure draft. However, we believe, that certain edits should be incorporated to the proposed Guidance Note on account of the following reasons:

Para 12(c) of the Exposure Draft as reproduced below

"The amount as (b) above may be transferred either proportionately each year, i.e., proportionately as assets resulting in capital reserve are depreciated/ impaired/amortised or at end on sale of the asset".

While the proportionate method seems reasonable for depreciation/ amortisation, it may not be appropriate for impairment.

The proposed guidance note gives analogy of Ind AS 16 Property, Plant and Equipment, "the revaluation surplus included in equity in respect of an item of property, plant and equipment may be transferred directly to retained earnings when the asset is derecognised. This may involve transferring the whole of the surplus when the asset is retired or disposed of.

However, some of the surplus may be transferred as the asset is used by an entity. In such a case, the amount of the surplus transferred would be the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset's original cost.

Transfers from revaluation surplus to retained earnings are not made through profit or loss."

Basis the above position, where an asset acquired in a business combination has led to recognition of capital reserves, and such asset is subsequently impaired, the amount of this capital reserve should be transferred to free reserves to the extent of impairment recorded against those assets.

Hence, we are of the view that paragraph 12(c) should be modified and drafted in the following manner:-

The amount as (b) above may be transferred either proportionately each year, i.e., proportionately as assets resulting in capital reserve are depreciated/ impaired/ amortised or at end on sale of the asset. In case of impairment of assets, the amount as

(b) above may be transferred to the extent of assets resulting in capital reserve are impaired.

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Appendix to the Guidance Note

The Appendix of the Guidance Note includes some examples to explain the timing when a reserve becomes realised. Therein, the examples (a) and (b) in the appendix mention that:

"The amount in capital reserve become realised as these assets are depreciated/ impaired by charge to P&L or on sale".

The above examples do not factor in scenarios where, a business combination that was initially accounted for under Indian GAAP and then restated under Ind AS in accordance with Ind AS 101 and Ind AS 103. The depreciation/impairment pertaining to the period between the date of acquisition and date of transition to Ind AS, shall be accounted for in retained earnings and not routed through P&L.

In our view, that Research Committee intended to cover such transactions as well, through the the examples stated under (a) and (b). By restricting the examples to items routed through P&L, the intent of the GN may get misrepresented.

Hence, we recommend that the words 'by charge to P&L' may be deleted. Paragraph (a) and (b) to the Appendix should be modified in the following manner: -

a. A company has bargain purchase gain resulting from business combination which is recognised in capital reserve. Bargain purchase has arisen mainly due to fair valuation of property, plant and equipment and intangible assets. The amount in capital reserve become realised as these assets are depreciated/ impaired ~~by charge to P&L~~ or on sale.

b. A company has capital reserve arising from common control business combination approved by the NCLT because carrying amount of net assets acquired is more than face value of shares issued and identifiable reserves. The amount in capital reserve become realised as these assets are depreciated ~~by charge to P&L~~ or on sale.

In Conclusion

This is an important update brought in by the Institute of Chartered Accountants of India, which will provide relief to companies by enabling them to utilise the realised gains.

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